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In the Supreme Court of the United States

OCTOBER TERM, 1973

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THE MUTUAL BENEFIT LIFE INSURANCE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in this case.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Appendix A, *infra*, pp. 1A–18A) are reported at 58 T.C. 679. The opinion of the court of appeals (Appendix B, *infra*, pp. 19A–35A, including an order amending the opinion) is reported at 488 F. 2d 1101.

JURISDICTION

The judgment of the court of appeals was entered on December 12, 1973 (Appendix C, *infra*, p. 36A). By

order dated March 1, 1974, Mr. Justice Brennan extended the time for filing a petition for a writ of certiorari to and including May 11, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the term "life insurance reserve" in the provisions of the Internal Revenue Code governing the income taxation of life insurance companies, is limited to those amounts derived from premiums which are necessary to cover the obligation to pay the face amount or the cash surrender value of the policy, or whether it also includes reserves to cover anticipated contingent obligations under the policy, such as those resulting from the elections of life annuity settlement options upon the maturity of previously issued polices.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Section 801 of the Internal Revenue Code of 1954 and of Treasury Regulations on Income Tax (1954 Code), § 1.801–4, are set forth in Appendix D, *infra*, pp. 37A–43A.

STATEMENT

Respondent is a mutual life insurance company incorporated in New Jersey. Certain life insurance policies issued by respondent from 1908 through September 16, 1945 ("P–Policies") permitted the policy-holder prior to maturity, or the beneficiary after maturity, to select one of several settlement options in lieu of lump-sum payment of the face amount of the policy upon maturity. One of these settlement options consisted of periodic payments of a specific amount over a minimum fixed period, and con-

tinuing during the life of the beneficiary or beneficiaries. The payments to be made under this lifetime annuity settlement option were set forth in schedules that were part of the policies, stating the dollar amount for each $1,000 face amount of the policy. These periodic annuity payments varied in amount with (1) the length of the fixed period; (2) the frequency of payments; (3) the age or ages of the beneficiary or beneficiaries; and, in some of the later policies, (4) the sex of the beneficiary or beneficiaries (Appendix A, *infra*, pp. 2A–3A.

Since the issuance of respondent's P–Policies, there has been a substantial increase in life expectancy at all ages. As a result, respondent received more premiums than were necessary to fund its insurance policies. As a mutual company, respondent was obligated either to return the excess to its policyholders as dividends or add it to surplus. However, the increase in life expectancy had the opposite effect upon such annuities as were elected as settlement options. The continuing increase in life expectancy caused the amounts payable under the insurance policies to be inadequate as reserves for the life-time annuities which might be elected under the settlement options. This was the case despite the fact that respondent from time to time (1922, 1932, 1936, and 1938) revised its policy forms and the schedules of payments under the annuity settlement options in accordance with more current actuarial assumptions (Appendix A, *infra*, pp. 3A–4A).

Respondent designated as "strain" the difference between the face amount of an insurance policy and the amount required to fund (*i.e.*, as an adequate

reserve) the particular annuity contract when an annuity settlement option was elected. Prior to 1946, it charged this amount to current surplus when the election became effective (Appendix A, *infra*, pp. 4A–5A).

In 1946, the New Jersey legislature enacted a statute (now § 17:34–22.1, N.J. Stat. Ann.) entitled "Additional Reserves," providing, in part, as follows:

> Subject to the approval of the commissioner, any life insurance company of this State may set up, in addition to the reserve liabilities required pursuant to section 17:34–22 of the Revised Statutes, reserves to provide for any additional liability at maturity, on the basis of rates of interest and of mortality appropriate to the valuation of annuities, on policies under which by their terms or otherwise a right has been or may be exercised to elect optional modes of settlement.

The statute further provided that the State insurance commissioner should include such additional reserves in the amount of reserves certified, and that the basis of any such reserves once set aside should not be changed to a basis producing smaller reserves except upon the commissioner's approval (Appendix A, *infra*, pp. 5A–6A).

Following the enactment of this statute, respondent established an Additional Reserve to provide in anticipation for annuity settlement options with respect to P–Policies which had not yet matured. In computing the Additional Reserve, respondent employed the 1937 Standard Annuity Mortality Table, adjusted, and an assumed rate of interest of 2¾ percent. But it was also necessary for it to make some estimate of (1) the projected rate of election of annuity settlement

options; (2) the age and sex of beneficiaries; (3) the amount of policy proceeds that would become subject to election; and (4) the future dates on which such elections would become effective (Appendix A, *infra*, pp. 6A–7A).

Respondent first assumed that the actual rate of "strain" it had experienced in 1945 would continue for the duration of the P–Policies. It thereby estimated that an Additional Reserve of approximately $37,000,000 would be required. However, respondent did not establish an Additional Reserve in that amount at once Instead, with the approval of the New Jersey Commissioner of Insurance, respondent allocated lesser amounts annually to its Additional Reserve, so that at the end of 1953 its Additional Reserve was approximately $21,404,000. As of December 31, 1956, the Additional Reserve was approximately $21,200,000 (Appendix A, *infra*, pp. 6A–7A).

Thereafter, respondent took into account its experience for the years 1952 through 1956, and projected the amounts required to meet "strain" through the year 2031, when all of the P–Policies would have matured. It discounted these amounts to January 1, 1957, and on that basis determined an Additional Reserve of $18,586,369 as of that date (Appendix A, *infra*, pp. 7A–9A.

Adjusting the figure it had established for January 1, 1957, respondent included Additional Reserves in the amounts of $17,941,445, $17,554,121.50, and $17,188,515 among its life insurance reserves on its federal income tax returns for 1958, 1959, and 1960, respectively (Appendix A, *infra*, p. 9A). On audit, the

Commissioner of Internal Revenue determined deficiencies of $295,077.97, $296,495.14, and $296,297.16, for those years, on the ground that the Additional Reserve was not a "life insurance reserve" within the meaning of Section 801(b) of the Internal Revenue Code of 1954, because, among other things, it was not derived from premiums paid by policyholders and was computed on the basis of factors other than recognized mortality tables and assumed rates of interest (Appendix A, *infra*, p. 1A).

Viewing the Additional Reserve established by respondent as indistinguishable "from the obligation * * * to pay a death benefit under a life insurance contract" (Appendix A, *infra*, p. 15A), the Tax Court set aside the deficiencies determined by the Commissioner (Appendix A, *infra*, pp. 11A–18A; Appendix B, *infra*, p. 25A). After noting that "the establishment of the 'additional reserve' was the exercise of good business judgment, was in the best interest of policyholders and beneficiaries, and had the approval of the State of New Jersey," the court of appeals affirmed (Appendix B, *infra*, pp. 28A, 19A–35A).

REASONS FOR GRANTING THE WRIT

1. In holding that a reserve not derived from net premiums established by a life insurance company to meet a contingent contractual liability is a life insurance reserve, the decision below conflicts with this Court's rulings in *Helvering* v. *Inter-Mountain Life Ins. Co.*, 294 U.S. 686, and *Helvering* v. *Illinois Ins. Co.*, 299 U.S. 88. See also *Continental Assur. Co.* v. *United States*, 8 F. Supp. 474, 478–479 (Ct. Cl.).

The expansive scope accorded by the decision below

to the definition of a life insurance reserve cannot be reconciled with a long series of decisions of this Court dealing with the income taxation of insurance companies and focusing on the nature and function of an insurance reserve. *E. g., McCoach* v. *Insurance Co. of North America,* 244 U.S. 585; *United States* v. *Boston Insurance Co.,* 269 U.S. 197; and *New York Life Ins. Co.* v. *Edwards,* 271 U.S. 109.

Finally, the conclusion of both courts below that a life insurance reserve can be established by an insurance company with respect to annuity contracts which it has a contingent obligation to issue, but has not yet issued, is in conflict with the decision on that question in *Jefferson Standard Life Ins. Co.* v. *United States,* 408 F. 2d 842, 859–860 (C.A. 4), certiorari denied, 396 U.S. 828, under the current statute, as well as with the earlier decision of this Court in *New York Life Ins. Co.* v. *Edwards, supra,* 271 U.S. at 119–120. This Court should resolve the conflict in order that a uniform rule be established with respect to this issue.

Under the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959, 73 Stat. 112, the amount of the life insurance reserve, defined in Section 801(b), is the base figure from which is determined, by methods provided in Sections 804, 805, and 809(a), the policyholders' share of investment income, which is exempt from tax. The remainder of the investment income is allocated to the company's share and is subject to tax under Section 802(b)(1). For present purposes, it is sufficient to state that the greater the amount of a company's life insurance reserve, the

larger the share of investment income that will be allocated to the tax-exempt policyholders' share and the smaller the company's income tax liability. See *Western Natl. Life Ins. Co.* v. *Commissioner*, 432 F. 2d 298, 300 (C.A. 5).

The fundamental role of the life insurance reserve concept in the federal taxation of life insurance companies is not limited to the present statute. "Reserve funds" or the "life insurance reserve" have occupied a central position in every income tax statute. Beginning with the Corporation Excise Tax Act of 1909, 36 Stat. 112, until the Revenue Act of 1921, 42 Stat. 227, insurance companies were taxed substantially as other corporations, but were allowed a deduction for "the net addition, if any, required by law to be made within the year to reserve funds." Corporation Excise Tax Act of 1909, Section 38, Second. From 1921 to 1959, only investment income of life insurance companies was subject to tax, and there was excluded or deducted from the taxable investment income a percentage of "reserve funds" or of the "life insurance reserve." [1]

The first statutory definition of the "life insurance reserve" was adopted in Section 163 of the Revenue Act of 1942, 56 Stat. 798, amending Section 201 of the Internal Revenue Code of 1939, and has been substantially carried forward since that time. As both House and Senate Committee Reports accompanying the 1942

[1] The various formulations that were employed after 1921 are set forth in S. Rep. No. 291, 86th Cong., 1st Sess., pp. 3–6, together with a summary of the equivalent provisions of the current statute.

Act noted, the statutory definition was "substantially that contained for many years in the regulations." H. Rep. No. 2333, 77th Cong., 2d Sess., p. 109; S. Rep. No. 1631, 77th Cong., 2d Sess., p. 145. Those regulations, in turn, reflected the decisions of this Court, with which the decision below is in conflict. See *e.g.*, Treasury Regulations 103 (1939 Code), § 19.203(a)(2)–1. The current statutory definition of a life insurance reserve, set forth in Section 801(b)(1) of the Code, which was enacted in 1959, similarly reflects the decisions of this Court which have considered the nature and function of such a reserve.[2]

Thus, the life insurance reserve concept has been a significant element in the taxation of life insurance companies for 65 years. While there have been variations among the successive legislative approaches to the taxation of life insurance companies, the differences have been largely computational. The critical starting point, however, has always been the amount of the life insurance reserve which has been consistently defined by longstanding rulings of this Court.

The misconception of the courts below as to the nature of a life insurance reserve is completely at odds with those rulings and is far more fundamental to the taxation of life insurance companies than the computational issue which the Court considered in *United States* v. *Atlas Life Ins. Co.*, 381 U.S. 233. It is therefore understandable that the revenue impact of the decision below is substantial. We are

[2] The structure and operation of the present statute are summarized in *United States* v. *Atlas Life Ins. Co.*, 381 U.S. 233, 235–238, and *Jefferson Standard Life Ins. Co.* v. *United States*, 408 F. 2d 842, 844–846 (C.A. 4).

advised by the Internal Revenue Service that an examination of the major life insurance companies shows among them "unmatured settlement option" reserves of $237,000,000. The total amount of tax in dispute presently pending administratively in the Internal Revenue Service on this issue is $59,700,000, of which $11,000,000 involves insurance companies which can sue in the Third Circuit.[3] There is an additional $13,000,000 at issue in three separate cases pending in the Court of Claims. Moreover, beyond the specific issue relating to anticipatory reserves with respect to settlement options, any distortion of the fundamental statutory concept of the life insurance reserve will have widespread and pervasive effects upon the taxation of life insurance companies.

2. (a). Before turning to the question presented in this case, a brief discussion of the nature of a life insurance reserve is appropriate. As the standard texts on life insurance make clear,[4] a life insurance

[3] Five of the 50 largest insurance companies are located within the Third Circuit. They are: Prudential Life Insurance Company (No. 1), Mutual Benefit Life Insurance Company (No. 15), Penn Mutual Life Insurance Company (No. 16), Provident Mutual Life Insurance Company (No. 28), and Fidelity Mutual Life Insurance Company (No. 47).

[4] We have attached as Appendix E, *infra*, pp. 44A–52A, pertinent passages from MacLean, *Life Insurance* (9th ed.). The author has been Vice-President and Actuary of Mutual Life Insurance Company of New York; Fellow, Faculty of Actuaries (Edinburgh); President, Actuarial Society of America. While other texts are cast in somewhat more technical terms, they are to the same effect on this basic point. See *e.g.*, Huebner and Black, *Life Insurance* (7th ed); Magee, *Life Insurance* (3d ed.); McGill, *Life Insurance* (Rev.).

reserve is made up of the sum of net premiums, plus interest at the assumed rate, less claims paid. The premium to be charged for life insurance is made up of three elements: mortality, interest, and expense. When a premium is to be established, a mortality table must first be chosen, and then a rate of interest that can safely be assumed will be produced by funds invested. With these elements established, the *net premium* can be calculated. Net premiums, plus interest at the assumed rate, will be adequate to pay all claims on the assumption that deaths will take place according to the mortality table. When the company's estimated expense, or "loading charge" is added, the gross premium that is charged policyholders is obtained. As explained and illustrated in Appendix E, *infra*, pp 47A–52A, the life insurance reserve is simply the sum of net premiums paid, plus interest at the assumed rate, minus claims paid.

The opinions and decisions of this Court are fully in accord with this definition. Thus, for example, Chief Justice Hughes, whose experience in life insurance was extensive, explained the nature of a life insurance reserve in *Williams* v. *Union Central Life Ins. Co.*, 291 U.S. 170, 177, as follows:

> With the mortality table and an assumed rate of interest on the investment of premiums received, the amount of the accumulated savings on this basis, at any date, can be mathematically computed. This amount constitutes the "reserve" against the policy or its net value. The insurer must have on hand the aggregate amount of these reserves against its outstand-

> ing policies. And in case of lapse, after a policy has been in force for a specified time, its net value or "surrender value," less surrender charges, is made available to the policyholder.

See also *New York Life Ins. Co.* v. *Bowers*, 283 U.S. 242, 244; *Commissioner* v. *Monarch Life Ins. Co.*, 114 F. 2d 314, 319–320 (C.A. 1).

(b) The foregoing discussion demonstrates that a life insurance reserve is one derived from the net premiums received by the company. Unlike the general term "reserve" which is used by accountants to denote a book entry representing an anticipated loss or expenditure as a charge against current income, a life insurance reserve is simply the total of the net premiums paid invested at an assumed rate of interest, minus claims paid. The life insurance reserve therefore represents the company's ability to pay either the face amount of the policy at death or the lesser cash surrender value upon cancellation or request. A "reserve" for any other liability of the company is by definition not a life insurance reserve because it is not derived from net premiums plus interest at an assumed rate.

This Court has long recognized this distinction between a life insurance reserve and other types of insurance company reserves. In a series of decisions, the Court has held that reserves established to meet anticipated losses or expenditures were not "reserve funds" for purposes of the income tax statutes even though they were required by state law. See *McCoach* v. *Insurance Co. of North America*, 244 U.S. 585, 589 (re-

serve for unpaid losses); *United States* v. *Boston Insurance Co.*, 269 U.S. 197 (loss claim reserves); *New York Life Ins. Co.* v. *Edwards*, 271 U.S. 109 (reserve for unreported losses). The Court's statement in the latter case is illustrative of the rationale of these holdings—"The item under consideration represented a liability and not something reserved from premiums to meet policy obligations" (271 U.S. at 119).[5]

Since these rulings of the Court firmly repudiate the notion that an insurance reserve can be established with respect to anticipated losses, they all can be said to conflict with the decision below insofar as it is based upon that discredited rationale. The "strain" between the face amount of respondent's P–Policies and the amount necessary to fund a life-time annuity for a beneficiary is such an anticipated loss. One of the decisions of this Court most closely bearing upon the question whether respondent's "Additional Reserve" is a life insurance reserve is *Helvering* v. *Inter-Mountain Life Ins. Co.*, 294 U.S. 686, which indicates that it is not such a reserve.

There, a stock company, in order to compete with the dividends paid by mutual companies, attached coupons to its 20-payment life insurance policies.

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[5] See also *Duffy* v. *Mutual Benefit Life Ins. Co.*, 272 U.S. 613, where the Court equated the "legal reserve," derived from premiums and the earnings thereon, with "invested capital" for purposes of the excess profits tax under the Revenue Act of 1917, 40 Stat. 300, noting (*id.* at 619) that the reserve was contributed by the members of the mutual insurance company, as invested capital was contributed by stockholders of other corporations.

These coupons matured annually and were redeemable either in cash or by application to the premium currently due. If neither of these options was elected, the company would pay the coupon values with interest to the beneficiary upon the death of the insured in addition to the face amount of the policy. If not redeemed prior to 20 years, the coupons could be converted in accordance with a number of options, which as in this case included a life-time annuity.

Although Utah law required the company to maintain a reserve for matured and unpaid coupons, the Court unanimously held that this reserve could not be included in the company's "reserve required by law" for income tax purposes. In so concluding, the Court stated in terms most appropriate to this case (294 U.S. at 690):

> The word "reserve" has many meanings. Accounts creating reserves are set up in almost every line of business, and funds evidenced by the book entries are held for many and widely different purposes. As the Act does not permit corporations other than insurance companies to make deductions of the kind here under consideration, *"reserve funds" may not reasonably be deemed to include values that do not directly pertain to insurance.* In life insurance the reserve means the amount, accumulated by the company out of premium payments, which is attributable to and represents the value of the life insurance elements of the policy contracts. [Emphasis supplied.] * * *

Because the reserve for matured and unpaid coupons in the *Inter-Mountain Life Ins. Co.* case did not "di-

rectly pertain to insurance," it could not be included in the reserve for income tax purposes. Similarly, here, the "Additional Reserve" has nothing whatever to do with respondent's obligation to pay the face amount of the policy upon the death of the insured or the lesser cash surrender value. That life insurance obligation was fully funded by the net premiums it received. However, its contingent obligation to provide a lifetime annuity to the beneficiary is completely extraneous to the life insurance risks it incurred under the policy.[6] See also *Helvering* v. *Illinois Life Ins. Co.*, 299 U.S. 88, where on the authority of *Helvering* v. *Inter-Mountain Life Ins. Co., supra,* the Court held that a reserve to meet an obligation to provide a tontine fund was not a reserve fund for income tax purposes because it "ha[d] no relation to life insurance risks" (299 U.S. at 91).

In short, as the history of federal income taxation of life insurance companies shows and as this Court's decisions recognize, Congress used the phrase "life insurance reserves" as words of art to describe a particular kind of reserve, namely, one designed to provide an amount sufficient to pay either the face amount of the policy or its cash surrender value. The basic error of the court of appeals was its failure to recognize this, and its consequent treatment of "life insurance reserves" as a general concept also cover-

[6] For a more extensive discussion of the coupon reserve, see *Continental Assur. Co.* v. *United States*, 8 F. Supp. 474 (Ct. Cl.), which is in accord with *Helvering* v. *Inter-Mountain Life Ins. Co., supra*, and cited therein with approval (294 U.S. at 690).

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ing reserves created to satisfy additional contingent obligations which the company may be required to satisfy under various settlement options that may be invoked when the policy matures.

3. As a result of its misconception of the nature of a life insurance reserve, the decision below also conflicts with *Jefferson Standard Life Ins. Co.* v. *United States,* 408 F. 2d 842, 859–860, certiorari denied, 396 U.S. 828, and *New York Life Ins. Co.* v. *Edwards,* 271 U.S. 109, 119–120, on the question whether a contingent obligation of an insurance company to provide an annuity not yet issued can be included in its life insurance reserves. In those cases, the company claimed additions to its life insurance reserve for annuities which it might have had to provide to certain of its employees who completed a specified period of service. However, the obligation to issue the annuity did not arise until the employee qualified. In the event of early termination, the employee received nothing. Under those circumstances, both this Court, under the prior act, and the Fourth Circuit, under the present statute, held that such a contingent contractual obligation to issue an annuity could not be included in the company's insurance reserves.

For purposes of analysis, the company and its employees in *Jefferson Standard* and *New York Life Insurance Co.* stand in exactly the same position to each other as respondent and the beneficiaries under the P–Policies who might elect life-time annuities. In both situations, the obligation to issue the annuity depended upon factors which were wholly extraneous to mortality risks and assumed rates of interest upon

which net premiums are calculated and upon which insurance reserves are based. That the obligation here arose under the policy is not significant, for it did not pertain to the life insurance aspect of the policy.

Despite the company's contractual obligation under the policy to issue the annuity under the settlement option, the issuance of such an annuity is a wholly separate and independent transaction under which the beneficiary purchases the annuity with the face amount of the policy payable upon the death of the insured. Cf. Section 101(d) of the Code. As the Court of Claims long ago stated in rejecting a similar argument in *Continental Assur. Co.* v. *United States,* 8 F. Supp. 474, 481 (Ct. Cl.):

> The controversy in the case at bar arises from the fact that the plaintiff is insisting that the words "policy obligations" [as used by this Court in *New York Life Ins. Co.* v. *Edwards, supra*] refer not alone to obligations calculated upon the basis of the mortality tables selected, together with the rate of interest assumed, but that these words include any obligation assumed by the company under its contracts. But we cannot agree with this position.

To be sure, an annuity contract embodies the same principles of mortality and an assumed rate of interest as a life insurance policy, and Section 801(b)(1)(B) of the Code includes annuity reserves in the definition of a life insurance reserve. But there can no more be a life insurance reserve with respect to an annuity contract prior to the payment of the premium

or premiums and issuance of the contract than there can be with reference to an insurance policy not yet issued and with respect to which no premiums have been paid. See *Continental Assur. Co.* v. *United States, supra,* 8 F. Supp. at 478–479. A non-existent obligation which may only possibly arise in the future cannot be the basis of an insurance reserve which will affect current tax liabilities.

Indeed, even if it were possible to have a life insurance reserve with respect to annuity contracts not yet effective or issued, respondent's reserves do not meet the test in Section 801(b)(1)(A) of the Code, which requires that such reserves be computed only on the "basis of recognized mortality * * * tables and assumed rates of interest." This statutory provision of course reflects the nature of a life insurance reserve as that concept is understood by the insurance texts and the teaching of this Court.[7] The conclusion of the court of appeals (Appendix B, *infra*, p. 31A) that "[t]here is nothing in the statute which states that these two elements are the only factors which are per-

[7] The administrative position of the Internal Revenue Service has consistently been that life insurance reserves may be based only upon the contingencies of mortality and an assumed rate of interest and that a reserve which embodies other contingencies does not meet the statutory requirements. See *e.g.*, Rev. Rul. 67–435, 1967–2 Cum. Bull. 232; Rev. Rul. 68–441, 1968–2 Cum. Bull. 293; Rev. Rul. 69–302, 1969–1 Cum. Bull. 186.

missible and that all others must be excluded" necessarily rejects those authorities.[8]

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[8] The court of appeals was likewise erroneous in its construction of Section 801(b)(2) of the Code, which provides that "life insurance reserves must be required by law." The New Jersey statute in this case permitted the establishment of respondent's Additional Reserves but imposed the restriction that once such a reserve was established, it could not thereafter be set aside. On the basis of this latter restriction, the court of appeals concluded that the respondent's Additional Reserves were "required by law." But a free choice or an election is no less a free choice or election because it may not be revoked after it is made. Once respondent published to its policy-holders and prospective policy-holders an enlarged measure of financial stability, there is every reason why it should have been unable to change its course at will. But for purposes of the Internal Revenue Code and income taxation, that fact is irrelevant.

Moreover, the decision below fails to pay heed to the exclusion of "deficiency reserves" from the definition of a life insurance reserve. See Section 801(b)(4) of the Code. It is apparent that the existence of what respondent termed "strain" upon the issuance of its annuity contracts when life-annuity settlement options were elected would have been an occasion giving rise to a deficiency reserve had it not made a charge to surplus. It is equally apparent that its Additional Reserve was in anticipation of such strain. An anticipatory deficiency reserve is no more a life insurance reserve than the deficiency reserve itself, occurring when the annuity contract is issued for less than the net premium required. The exclusion of this anticipatory deficiency reserve would follow a *fortiori* from the statutory exclusion of a deficiency reserve.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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MAY 1974.

APPENDIX A

THE MUTUAL BENEFIT LIFE INSURANCE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 3671–70. Filed July 27, 1972

A reserve to fund the additional cost of providing annuities to the beneficiaries under its life insurance policies, expressly authorized by State statute, which became subject to the regulatory authority of the State commission, qualified as a life insurance reserve within the meaning of sec. 801(b)

Henry W. Connelly, Charles W. Kappes, Michael J. Walsh, and *James A. Guadiana,* for the petitioner.

Gerald Backer, for the respondent.

QUEALY, *Judge:* The respondent determined deficiencies in petitioner's income taxes as follows:

Year:	*Deficiency*
1958	$295,077.97
1959	296,495.14
1960	298,297.16

The sole question involved is whether an additional reserve established by the petitioner to supplement the basic policy reserve in meeting its obligations under the optional mode of settlement contract embodied in certain of its policies qualified during the years 1958, 1959, and 1960 as a life insurance reserve as defined in section 801(b).[1]

[1] All statutory references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

The Mutual Benefit Life Insurance Co. (hereinafter referred to as the petitioner) is, and was at all times material herein, a mutual life insurance company incorporated by act of the New Jersey Legislature on January 31, 1845.

The petitioner's principal place of business is now, and was at the time of filing its petition, located in Newark, N.J. The petitioner timely filed its Federal income tax returns for the taxable years ended December 31, 1958, December 31, 1959, and December 31, 1960, with the district director of internal revenue, Newark, N.J. Said tax returns were prepared on the basis of an accrual method of accounting.

The petitioner is subject to the provisions of the New Jersey State laws applicable to the operation of mutual life insurance companies and to the regulations promulgated pursuant to such laws by the State of New Jersey Department of Banking and Insurance.

Life insurance policies issued by the petitioner from 1908 through September 16, 1945 (hereinafter referred to collectively as the P-Policies) provided that the policyholder, prior to maturity of the policy, or the beneficiary, upon the maturity of the policy, might elect either (1) to leave the policy proceeds with the petitioner at interest; (2) payment of the proceeds in installments for a period certain (i.e., a guaranteed income for a minimum period regardless of the life of the beneficiary or beneficiaries); or (3) the payment of a specified amount for a period certain continuing for the life of the beneficiary or beneficiaries. The option with a life contingency, the third category

described, is hereinafter referred to as the settlement option.

The payments to be made in the settlement options under the P-Polices were embodied in a schedule setting forth the dollar amount of each installment payment for each $1,000 of insurance, in accordance with (a) a period certain; (b) the frequency of payment; (c) the age or ages of the beneficiary or beneficiaries; and (d) in certain policies, the sex of the beneficiary or beneficiaries. Under the terms of the P-Policies, the installments payable under the settlement options were guaranteed, and the petitioner was bound to pay such amounts. From time to time, the petitioner changed both the policy forms used in issuing the P-Policies and the actuarial assumptions used in constructing the schedule for this settlement option, as follows:

(1) The payments under the settlement option contained in the policy forms adopted in 1908 were computed by the petitioner on the basis of interest at the rate of 3 percent per annum for the period certain and on the basis of McClintock's Mortality Table—Females and interest at the rate of 3½ percent per annum for the deferred life period following the period certain.

(2) The payments under the settlement option contained in the policy forms adopted in 1922 were computed by the petitioner on the basis of the American Experience Table of Mortality and interest at the rate of 3 percent per annum.

(3) In 1932, the petitioner adopted a retirement endowment policy form which introduced a joint and survivor settlement option. The payments under this joint and survivor settlement option were computed by the petitioner on the basis of interest at the rate of 3 percent per annum for the period certain and on the

basis of the American Annuitants' Table, adjusted by rating down 1 year in age for males and 5 years in age for females and by using only the ultimate portion thereof, and interest at the rate of 3½ percent per annum for the deferred life period.

(4) In 1936, the petitioner adopted a retirement endowment policy form which contained settlement options for use in insuring females. The payments under this settlement option were computed by the petitioner on the basis of the American Annuitants' Table for male lives, adjusted by rating down 1 year in age for males and 5 years in age for females, and interest at the rate of 3 percent per annum.

(5) In 1938, new policy forms were adopted by the petitioner for all plans of insurance. These forms contain settlement options, the payments under which were computed by the petitioner on the basis of interest at the rate of 3 percent per annum for the period certain and for the deferred life period on the basis of the American Annuitants' Table for male lives, adjusted by rating down 3 years in age for males and 7 years in age for females and by using only the ultimate portion thereof, and interest at the rate of 3½ percent per annum.

Following the issuance of the P-Policies, there was a substantial lengthening of the life expectancy at all ages and a corresponding decrease in the rate of mortality. As a result, it became apparent that the lump-sum payment otherwise due on a policy, which was reflected in the reserve, would be inadequate to fund the petitioner's liability in the event that the insured or the beneficiary elected the settlement option.

The decrease in the rate of mortality also resulted in the realization of additional income to the petitioner from these same policies by reason of the fact that petitioner was receiving premiums for a greater

number of years and in an amount in excess of the amount required to make payment of death claims under the policies. However, the excess in premiums received during the life of the policy was either distributed to the policyholder in the form of dividends or became a part of the surplus.

As a result of the foregoing, when a beneficiary elected the optional settlement under the P-Policies, the amount provided to pay death benefits was less than the amount that was required as a reserve for the annuity payments. This difference the petitioner denominated as "strain." The strain experienced by the petitioner upon an election differed depending upon the age and sex of the beneficiary.

Prior to the year ending December 31, 1946, the petitioner determined the actual strain at the time that the election of the settlement option became effective. At that time, the difference between the policy reserve and the amount required to fund the settlement option was charged against current surplus. Such a charge reduced the amount of current income available to the policyholders. As a result, the additional cost required to fund the settlement option served to increase the net premium cost of the remaining policyholders.

In the year 1946, the legislature of the State of New Jersey enacted a bill, appearing as section 17:34–22.1 of the New Jersey Statutes Annotated, as follows:

Sec. 17:34—22.1 Additional reserves

> Subject to the approval of the commissioner, any life insurance company of this State may set up, in addition to the reserve liabilities required pursuant to section 17:34–22 of the Revised Statutes, reserves to provide for any additional liability at maturity, on the basis of rates of interest and of mortality appropriate to the valuation of annuities, on policies

under which by their terms or otherwise a right has been or may be exercised to elect optional modes of settlement.

The commissioner shall, at the time of the annual valuation pursuant to section 17:34–22 of the Revised Statutes, make or cause to be made a valuation of the additional reserves so set up, and shall thereupon include the amount of such additional reserves in any certification of reserves made pursuant to section 17:34–22 of the Revised Statutes, specifying the mortality table or tables and rate or rates of interest used in the calculation of such additional reserves.

The basis of such additional reserves set aside by any company at the close of any year shall not thereafter be changed to a basis producing smaller aggregate reserves except upon approval by the commissioner of the company's application therefor. * * *

Following the enactment of section 17:34–22.1 of the New Jersey Statutes, the petitioner set about to establish, as of December 31, 1946, an additional reserve to provide for the settlement options contained in the P-Policies not yet matured (hereinafter referred to as the additional reserve). In computing the additional reserve, the petitioner adopted the 1937 Standard Annuity Mortality Table, adjusted by rating down 1 year in age, and an assumed rate of interest of 2¾ percent in the manner described below.

In the application of this table, however, it was necessary also to determine with respect to the P-Policies (a) the projected rate of election of settlement options; (b) the age and sex of beneficiaries; (c) the amount of the policy proceeds which become subject to election; and (d) the future date on which such election would become effective.

In determining the amount which would be required as an additional reserve for the P-Policies, the peti-

tioner first assumed that its additional liability, or strain, would remain at a constant percentage of policy proceeds arising from all death claims and endowment maturities under the P-Policies. This percentage was obtained by dividing the additional amounts needed in past years to provide for such additional liability on the basis of the 1937 Standard Annuity Mortality Table, adjusted, and an assumed rate of interest of 2¾ percent, by the policy proceeds arising from all death claims and endowment maturities for such past years.

The additional reserve requirements determined by the petitioner as of December 31, 1946, was thus based on the assumption that the actual strain which petitioner had experienced in the year 1945, as compared to the death proceeds paid in that year, would be in the same proportion in each succeeding year for the duration of the P-Policies. The strain thus computed was discounted at 3 percent per annum, which resulted in the estimate that approximately $37 million would be required for the additional reserve to fund the optional settlement costs as of December 31, 1946. Due to the fact that the charge of the full amount to surplus in that year would result in a corresponding reduction in the dividends payable to its policyholders, the petitioner elected not to set up the full amount of its estimate. In lieu thereof, lesser amounts were set up each year thereafter until the year ending December 31, 1953, when the additional reserve amounted to approximately $21,404,000. This amount remained fairly constant thereafter. As of December 31, 1956, the additional reserve amounted to approximately $21,200,000.

In computing the additional reserve which would be required as of January 1, 1957, the petitioner took into account its experience for the years 1952

through 1956, both inclusive. It determined the strain (additional liability) ratios for each such year by dividing the aggregate of initial reserves established on the basis of the 1937 Standard Annuity Mortality Table, adjusted, and an assumed rate of interest of 2¾ percent, less proceeds applied pursuant to settlement option elections, by the total proceeds maturing as death claims and endowments in each of these past years. The resulting strain as determined by petitioner was, as follows:

Year:	*Ratio*
1952	0.02284
1953	.02754
1954	.02647
1955	.02217
1956	.01972

The proceeds under the P-Policies amounted to approximately $200 million with an average policy size of $9,000 to $10,000, so that the number of P-Policies subject to settlement option elections was approximately 20,000 policies. The average strain ratio for this 5-year period was 0.02375.

The 1952–56 average strain of 0.02375 was then applied to the expected death claims and endowment maturities for each year beginning with 1957 and ending with 2031 (the year in which it was expected that the youngest P-Policyholder would reach age 96). Future death claims and endowment maturities were obtained by the use of the petitioner's mortality experience for 1952 through 1956 and a lapse rate of 1.75 percent which was also arrived at on the basis of the petitioner's experience.

Upon the basis of these calculations, the petitioner determined the amounts which would be required to meet the strain for the years 1957 through 2031. These amounts were then discounted to January 1, 1957, on the basis of an assumed rate of interest of 3 percent. In accordance with this procedure, the additional re-

serve required as of January 1, 1957, was determined to be $18,586,369.[2]

Using the same method of computation for the years 1957, 1958, 1959, and 1960, inclusive, the projected strain and actual strain were, as follows:

Year	Projected strain	Actual strain
1957	$1, 015, 729	$999, 065
1958	1, 055, 444	907, 217
1959	1, 077, 265	916, 560
1960	1, 093, 449	841, 529

Since the actual strain for 1957, and 1958 approximated the projected strain under the 1957 computation, the petitioner, with the consent of the New Jersey commissioner of banking and insurance, computed the additional reserve at December 31, 1957, 1958, 1959, and 1960 by increasing it by an assumed interest rate of 3 percent and reducing it by the actual strain for each year. The petitioner proposed "to continue this practice in the future until developments indicate that this course is not appropriate."

The amount of the additional reserve at January 1, 1958, 1959, and 1960, and December 31, 1958, 1959, and 1960, and the mean for the years 1958, 1959, and 1960 were as follows:

	January 1	December 31	Mean of year
1958	$18, 129, 909	$17, 752, 981	$17, 941, 445. 00
1959	17, 752, 981	17, 355, 262	17, 554, 121. 50
1960	17, 355, 262	17, 021, 768	17, 188, 515. 00

[2] This sum was $2,668,160 less than would have been required on the basis of the computation of the additional reserve originally made in 1946. The original computation made in 1946 followed the same methodology as the aforesaid 1957 calculation except that the 1941 Basic C.S.O. Table was used with respect to the life expectancies of the underlying insured persons instead of the petitioner's 1952–56 mortality experience.

The 3-percent interest addition to the reserve in each of the years 1958, 1959, and 1960 was $530,289, $518,841, and $508,035, respectively.

By reason of the fact that in each of the years 1958, 1959, and 1960, the additional reserve was computed by subtracting the actual strain from the opening balances in each year (as above described) petitioner necessarily reported no underwriting income from the annual reductions to the reserve.[3]

The additional liability of the petitioner under the settlement options contained in the P-Policies could not be provided for by means of the basic policy reserve held under section 17:34–22 of the New Jersey Statutes, nor by way of a change in the mortality or interest assumptions used in the calculation thereof.

At the time the gross premiums charged for the P-Policies were computed, it was assumed that the policy proceeds alone would fully fund the settlement options contained therein. Therefore, no portion of the premium was specifically or separately charged for the inclusion of the settlement options. The petitioner paid dividends on all of the P-Policies which were participating policies in each and every year. Beginning in 1948 and continuing through 1962, these P-Policy dividends were reduced because of dividend charges made in order to restore the amounts which were previously transferred from surplus to the additional reserve. Accordingly, the establishment of the additional reserve enabled the petitioner to assess the cost of the additional liability under the settlement options against the P-Policyholders.

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[3] In adopting this method of accounting, the petitioner achieved the same result that was provided for by the exclusion in sec. 801(b)(4) of deficiency reserves. H. Rept. No. 34, 86th Cong., 1st Sess., p. 18, 1959–2 C.B. 748.

During the years in issue, the petitioner held deficiency reserves required by the laws of the State of New Jersey with respect to certain life insurance and annuity policies. None of these deficiency reserves included the additional reserve or were related to the settlement options contained in the P-Policies.

OPINION

Petitioner is a mutual life insurance company organized under the laws of the State of New Jersey. Life insurance policies written by the petitioner provided for an election to receive the proceeds in installments payable for a period certain and continuing for the life of the beneficiary. At the time the policies were written, the amounts thus payable were determined by reference to the then current mortality tables and an interest factor predicated upon the estimated rate of return which would be realized by petitioner from the investment of its reserves.

During the intervening years between the writing of such policies and the occurrence of the insurable event, that is the death of the insured, there was a substantial increase in life expectancy at all age levels. In other words, both the insured and the beneficiaries of such policies were living on the average many years longer than the anticipated life expectancy which was used as a basis for fixing the premiums in the policies and the installments payable to the beneficiaries in the event of the election of the optional settlement. The basic policy reserve, which was predicated on the payment of a sum certain upon the death of the insured, was inadequate to fund the life annuity of those beneficiaries who were entitled to receive a specified amount in installments payable for a period certain and continuing for their respective lives. This inadequacy was termed "strain" by the petitioner.

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Prior to the years ending December 31, 1946, the amount of strain which was experienced on account of the election of the optional settlement was determined as of the date of death of the insured and the resulting deficiency served to reduce surplus. In other words, the strain became a current charge to operations at the time the election took effect and an annuity reserve was set up to provide for the payments thereunder.

During the year 1946, the legislature of the State of New Jersey enacted section 17:34–22.1 of the New Jersey Statutes which permitted, *but did not require,* the maintenance of an additional reserve to provide for any additional liability at maturity on the basis of rates of interest and of mortality appropriate to the valuation of annuities on account of life insurance policies which granted the right to elect optional modes of settlement. The statute further provided that the basis of such additional reserve shall not thereafter be changed to a basis producing smaller aggregate reserves except upon approval by the New Jersey commissioner of banking and insurance.

Prior to the years involved in this case, the petitioner had duly elected to establish an additional reserve on a basis which had been approved by the New Jersey commissioner of banking and insurance. Thus, over a period of years, an appropriate reserve had been set up voluntarily by the petitioner and upon a basis largely of petitioner's own choice. Having established such a reserve, the sole question for decision is whether the reserve qualifies as a "life insurance reserve" within the meaning of section 801(b), thereby entitling the petitioner to the exclusion provided in section 804(a). Insofar as material herein, section 801(b) provides as follows:

(b) LIFE INSURANCE RESERVES DEFINED.—

IN GENERAL.—For purposes of this part the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

(2) RESERVES MUST BE REQUIRED BY LAW.—Except—

(A) in the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, and

(B) * * *

in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

At the outset, respondent argues that in enacting the Life Insurance Income Tax Act of 1959 it was the intent of Congress to tax alike all life insurance companies. The respondent contends that allowing the petitioner to set up a life insurance reserve for the anticipated strain would result in a tax advantage to the

petitioner in relation to other life insurance companies not having such reserves. Since any decision with respect to the qualification of a reserve for the purpose of funding the annuity option in life insurance contracts would apply to all life insurance companies having such contracts, we regard respondent's argument wholly irrelevant to the issue in this case. The tax laws are replete with so-called tax preferences for those who qualify.

The respondent also contends that the additional reserve does not qualify as a life insurance reserve because it was not "computed or estimated on the basis of recognized mortality or morbidity tables" as required under section 801(b). Respondent argues that in the instant case there was involved the added element of uncertainty stemming from the election with respect to the settlement options and the uncertainty with respect to the age and sex of those electing in the future. Admittedly, however, it was the change in mortality rates predicated upon recognized tables that resulted in the inadequacy of the initial reserve to fund the settlement option. The determination of the amount required to fund the annuity at any specific age could be arrived at solely by reference to mortality tables and assumed rates of interest. Admittedly, it was also necessary to include in any computation of the reserve an assumed ratio of selection and the weighted average age or life expectancy of the beneficiary at the time of making the choice. Thus, while recognized mortality tables formed the basis of the petitioner's calculations of the reserve, the rate of selection and the profile of the annuitant had to be determined upon the basis of experience.

Respondent does not suggest that some other method would produce a different result. Rather, the respondent argues that the method itself goes beyond

the use of recognized mortality tables. If such judgments were not an integral part in the computation of insurance reserves, we would hardly have need for actuaries. The so-called actuary would still be known as the mathematician.[4] In our opinion, the combination of mortality tables and actual experience used by the petitioner to determine in the first instance the amount required to fund its liability for the settlement option under the P-Policies was within the scope of the statute.[5]

The respondent also points out that having determined the amount of the reserve which would be required, petitioner did not in a single year set up a reserve for the full amount that was thus determined. Charging the full amount to the reserve in one year out of its surplus would have made a corresponding reduction in dividends payable on account of its policies. Petitioner concluded that such reduction would be excessive. Assuming that a charge of the full amount to reserve in one year would have qualified as a life insurance reserve, the election by the petitioner to set up a lesser amount in each year over a period of years would not make the amount thus set aside any less qualified. *Lamana-Panno-Fallo I. Ins. Co.* v. *Commissioner,* 127 F. 2d 56 (C.A. 5, 1942).

Finally, we think it is clear that the reserve required to fund the optional settlement cannot be distinguished from the obligation of the petitioner to pay a death benefit under a life insurance contract. De-

[4] When petitioner was incorporated in 1845, its charter provided that there be a "mathematician," and petitioner's chief actuary is still known by that title.

[5] The reference to "recognized mortality or morbidity tables" first appeared in the Revenue Act of 1942. It was intended to expand, not to restrict, the definition of life insurance reserves. S. Rept. No. 1631, 77th Cong., 2d Sess., p. 145, 1942-2 C.B. 612.

pending upon changes both with respect to mortality rates and interest yields, the basic reserve under the contract could have been either greater or lesser than the amount required to meet petitioner's obligations under the optional settlement clause. Any additional reserve designed to provide for a deficiency in the basic reserve constitutes a reserve for the purpose of meeting the anticipated future obligation to pay benefits under a life insurance contract. The fact that such benefits may be payable in the form of an annuity, rather than a lump sum, does not change the character of contract.

We thus come to the basic question in this case, namely, whether it can be said that the additional reserve was "required by law" within the meaning of section 801(b)(2). The respondent contends that, since section 17:34–22.1 of the New Jersey Statutes provided in the first instance for a reserve that was discretionary or permissive, it was not required by law. On the other hand, the petitioner contends that the additional reserve was required by law since, once established, such reserve could not be diminished without the approval of the commissioner of insurance for the State of New Jersey.

On its face, the phrase "required by law" would appear to exclude a reserve which in the first instance was permissive rather than mandatory. In the taxation of the life insurance industry, however, we must look beyond the ordinary meaning of the words in the statute. *Alinco Life Insurance Co.* v. *United States,* 373 F. 2d 336, 352–353 (Ct. Cl. 1967).

Except for the reference to "recognized mortality or morbidity tables" the definition of life insurance reserves in section 801(b) was a codification of the respondent's regulations antedating the Revenue Act of 1942. S. Rept. No. 1631, *supra.* As used in those regu-

lations, the phase "required by law" referred not only to duly enacted State laws but to rules and regulations promulgated by duly authorized State regulatory agencies.[6] Section 1.801–5(b), Income Tax Regs., defines "required by law" as follows:

> (b) *Reserves required by law defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

Section 17:34–22.1 of the New Jersey Statutes not only permitted the setting up of a reserve for a recognized risk, but further provided that:

The basis of such additional reserves set aside by any company at the close of any year shall not thereafter be changed to a basis producing smaller aggregate reserves except upon approval by the commissioner of the company's application therefor. * * *

It cannot seriously be argued that the additional reserve voluntarily set up by the petitioner prior to the years before the Court was not required to be maintained by virtue of the regulatory power specifically granted to the State commissioner of banking and insurance. In the taxable years under consideration, therefore, there was on the books of the petitioner a reserve established in prior years pursuant to State law which had achieved the status of a reserve required to be maintained under the regulatory authority of the State agency. If we look to the re-

[6] Regs. 103, sec. 19.203(a)(2)–1.

spondent's regulations, this is tantamount to being "required by law" within the meaning of section 801(b).

As of January 1, 1958, the petitioner's additional reserve was "required" to be maintained by the commissioner of banking and insurance and was reported in the annual statements of the petitioner and accepted by the commissioner as held for the fulfillment of claims. It is our conclusion, therefore, that the additional reserve qualified as a life insurance reserve within the meaning of section 801(b).

In reaching this conclusion, it is not our intention to approve the manner in which the petitioner accounted for this reserve during the years in question. It would appear that the petitioner sought thereby to achieve the same result that was provided for by the Congress in excluding deficiency reserves from the overall computation of life insurance reserves. If it was necessary specifically so to exclude deficiency reserves under section 801(b)(4), it would seem to follow that proper credits and debits to other life insurance reserves not specifically so excluded should be taken into account in determining the tax base. However, the election of the petitioner to adjust the reserve on account of an assumed interest rate of 3 percent and reduce it by the actual strain for each year does not disqualify the reserve under section 801(b).

Reviewed by the Court.

Decision will be entered under Rule 50.

APPENDIX B

United States Court of Appeals for the Third Circuit

No. 73-1169

THE MUTUAL BENEFIT LIFE INSURANCE COMPANY, APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE, APPELLANT

Appeal From the United States Tax Court

Argued September 25, 1973

Before: Seitz, Chief Judge and Hunter and Weis, Circuit Judges

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Opinion of the Court

(Filed December 12, 1973)

WEIS, *Circuit Judge:* While there are many who complain that the Internal Revenue Code is incomprehensible, there are some few who revel in the intricacies of its labyrinthine composition. But those who take delight in such pursuits and who also understand the mystic processes of establishing reserves in the life insurance industry are an even rarer specie of the ornithological world. Such are the vagaries of assignments, however, that it has fallen to the lot of this panel to decide a case where the two sciences conjoin. We therefore tread into the thicket with some trepidation.[1]

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[1] No less an authority than Learned Hand once said, "In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave my mind only a confused sense of something vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time." Hand, *Eulogy of Thomas Walter Swan*, 57 Yale L.J. 167, 169 (1947).

The immediate question before us is whether the Tax Court properly decided that amounts allocated by the petitioner Insurance Company to an "additional reserve" qualify as "life insurance reserves" under Section 801 of the Internal Revenue Code of 1954 and the Life Insurance Company Tax Act of 1959, 26 U.S.C. § 801.

The problem is complicated by the fact that in the life insurance industry, as in many others, words acquire a technical significance, and the first step to confusion is to read these special terms as if they mean what they seem to mean. Thus, at the very outset, it is appropriate to note that contrary to generally held belief, "reserves" are not trust funds or assets in escrow but factually are merely statements of liability, involving no representation that specific assets are held to meet any particular claim or class of claims.[2] We are concerned here, therefore, with the computations of an amount which is to be entered on the balance sheet of an insurance company as a debit and, thus, has significant tax consequences.

The dispute here has its origin in a real life situation, to be exact, the substantial lengthening of life which occurred during the first half of the twentieth century.

Beginning in 1908 and continuing through 1945, the Insurance Company sold a series of life policies (called P-Policies) which gave the beneficiary the privilege of electing one of several methods of settlement in lieu of the customary face value lump sum payment. The option of concern here gives the beneficiary the right to receive payments for the rest of his life, but in no event for less than a stated number

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[2] Knickerbocker, *The present Status of Life Insurance Reserves*, 23 Tax Lawyer, Winter 1970, 367, 374 n. 22. 8 Mertens, *Law of Federal Taxation*, § 44.26 n. 1.

of these installments. The amount of each payment (which varies with the age of the beneficiary) is fixed and set forth in tables printed in the policy.

The tables were prepared on the assumption that the lump sum payment and the installment option would be roughly equivalent in value so that the liability of the Company in either event would be the same. However, as time went on and the lives of beneficiaries lengthened, it became obvious that the liability of the Company to meet the annuity-type option was becoming substantially greater than the lump sum payment. This situation developed because the amount of each monthly payment was fixed by the tables in the original policies based on life expectancies which were prevalent at that time. Since the beneficiaries began to live longer than the Company had anticipated at the time it wrote the contract, more payments were required and, hence, a greater total expenditure became necessary.

The petitioner had its headquarters in New Jersey, and that state's insurance laws required the Company to enter on its books annually a "basic reserve" which represented the amount that would be needed to meet the obligation to pay the face amounts of policies which became collectible that year. So long as the costs of lump sum payments and the time payment option were about the same, the accounting procedure was satisfactory and accurately reflected the Company's liabilities. When, however, the increasing longevity of beneficiaries required payment of sums beyond the amount of the basic reserves, an accounting problem was created.

The difference in amounts between the "basic reserve" and that required to settle under the settlement option was called "strain." Before 1946, the Company took the amount of "strain" from current surplus at

the time that a beneficiary elected to receive the payment option. The problem became increasingly acute, and in 1946 the Legislature of New Jersey enacted a statute (N.J. Stat. Ann. § 17:34–22.1) permitting an insurance company to set up "additional reserves" to meet the anticipated "strain" situation in future years.[3]

The statute provided that the establishment of such reserves initially would be voluntary but that once a company had availed itself of the privilege, reserves could not be changed to a basis producing smaller amounts thereafter except with approval of the insurance commissioner.

The Company decided to avail itself of the statutory provision and computed an "additional reserve" by using:

(1) The 1941 C.S.O. Mortality Tables,[4]

(2) The 1937 Standard Annuity Mortality Table, adjusted by rating down 1 year in age,

(3) An assumed rate of interest of 2¾% and additionally: (a) Projected rate of election of the settlement option, (b) Age and sex of beneficiaries, (c) Amount of policy proceeds which

[3] Because of the requirements of state law that reserves for the lump sum payment, the "basic reserve", be calculated on a rigid formula which made no provision for meeting the annuity-type option, it was not possible to increase that reserve to meet the "strain." Thus, although the Company took in more than enough in premiums to meet the "strain" obligation, the structure of state regulation required that the amount of premiums in excess of that required to maintain the "basic reserve" be transferred to surplus or returned to the policyholder in the form of dividends. Generally the Company returned the excess amounts to the policyholder as dividends.

[4] C.S.O. is the abbreviation for Commissioner's Standard Ordinary Table. It was based on the experience of a group of the principal insurance companies from 1930 to 1940. *See*, MacLean, *Life Insurance*, 9th ed. 1962 at 72.

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would become subject to election, and (d) The future date on which the election would become effective.

In computing the additional reserve requirements which would be required as of December 31, 1946, the Company assumed that the "strain" experienced in previous years, as compared to the lump sum death claims and endowment benefits paid, would remain at a constant ratio during the remaining years in which the P-Policies would be in effect, that is, to the year 2031. Rather than debit this amount in one year—which would have had a strong adverse effect on the Company surplus and reduce the dividends to policyholders—it was decided to strengthen the reserves over a period of years until the desired level was achieved. The computations and procedures followed by the Company were approved by the Insurance Commissioner of New Jersey.

As of December 31, 1956, the "additional reserve" amounted to $21,254,529.00. It was then decided to recalculate this reserve by utilizing the Company's experience during the preceding five years, that is, 1952 to 1956 inclusive. This resulted in a reduction for 1957 to $18,586,369.00.

In computing the "additional reserve" in 1956, the Company followed basically the same formula except that in this later calculation the mortality experience of the Company during the years 1952–1956 was used to determine the life expectancy of the *insured person* instead of the 1941 mortality table which was used in the 1946 calculation.[5] Both calculations, however, relied upon the use of the 1937 Standard Annuity Mortality Table in estimating the life of the *beneficiary* under the settlement option.

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[5] Findings of Fact of the Tax Court, n. 2.

The 1957 calculations were approved by the New Jersey Insurance Commissioner and resulted, as has been seen, in a reduction in the amount of the "additional reserve" from that which would have been applicable under the original calculation.[6] Similar mechanics were followed in determining the "additional reserve" for 1958, 1959 and 1960. The "additional reserves" as of December 31 for those respective years were $17,752,981.00; $17,355,262.00; and $17,021,768.00, respectively.[7]

The Commissioner assessed a deficiency for each of those years. After a trial, the Tax Court found against the Commissioner and determined that no deficiencies existed.[8]

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[6] This circumstance would result in a lesser exclusion, and hence the change in the Insurance Company's reserves would not adversely affect the government. Ordinarily one would not expect the Commissioner to object to such action. However, his attack here is to refuse recognition to the reserve in its entirety, claiming that the additional factors which were used to reduce the reserve destroyed its eligibility for inclusion altogether.

[7] The basic 1956 calculation was utilized in determining the 1958, 1959 and 1960 reserves. This was done by a method of increasing the reserve by 3¼ per year (the same yearly percentage which had been used in discounting the amount originally projected for the whole period of the P-Policy) and then deducting the actual "strain" incurred during each year. We are not called upon to pass on this particular accounting procedure since we are concerned in this appeal only with the determination of whether the reserves are properly denominated as insurance reserves.

[8] A more detailed statement of the facts and the mathematical computations involved may be found in the opinion of the Tax Court, 58 T.C. No. 69, Docket No. 3671-70, Filed July 27, 1972. We have limited our recitation of the factual background to that necessary for an understanding of the legal issues.

The Commissioner contends that the "additional reserves" do not qualify as life insurance reserves under the Act because:

> (1) Section 801(b)(2) requires that the establishment of the reserves be "required by law" and since the Insurance Company voluntarily established the reserve initially, that qualification was not met.
>
> (2) The Act, Section 801(b)(1)(a) defines a reserve as one computed on the basis of mortality tables and an assumed rate of interest. Therefore, since the calculations here used additional factors, such as lapse rate, rate of election, and company experience, the Commissioner contends that the reserve lost its eligibility to be considered as a life insurance reserve.
>
> (3) The Code excludes "deficiency reserves," and its definition would include the "additional reserve' here.

We first consider the qualification that the reserve be required by law. The income tax regulations, Section 1.801–5(b), defines "required by law" as follows:

> For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

The New Jersey statute applicable, that is, Section 17:34–22.1, permitted the setting up of an additional reserve but imposed the restriction that "The basis of such additional reserves set aside by any company at the close of any year shall not thereafter be changed

to a basis producing smaller aggregate reserves except upon approval by the commissioner of the company's application therefor * * *."

Thus, while the initial decision to set up a reserve was entirely voluntary, its continuance was not. What the Company did in 1946 was of its own choosing, but in 1958 to 1960 it was not free to drop the reserve or to alter its formulation without having specific permission from the Insurance Commissioner.[9] To argue that the Company was not required to carry the reserve in the years in question is to ignore reality. A man who volunteers for the Armed Forces is as subject to its discipline and regulations thereafter as any other person in service. His voluntary act in enlisting does not give him the right thereafter to question the lawful exercise of authority by his superiors. A man may enter into a marriage voluntarily, but that is not a reason to limit his obligation imposed by law to support his family. Similarly here, the Company could elect to take action permitted by the New Jersey statute, but when it did take that step, it did submit itself to the requirement that the reserve be continued thereafter. A fair reading of the income tax regulation requires us to conclude that in 1958–1960, the reserve was "required by law."

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[9] While not binding on this Court or the Tax Court, the opinion of the Insurance Commissioner of New Jersey who was charged with administration of the state law is entitled to some weight. He testified that "To the extent that the reserve was established, at that point it was required by law because it required the approval of the Commissioner for it to be reduced or eliminated." (Transcript of Testimony, p. 51). *See also* Knickerbocker, *supra*, n. 2 at 375:

"However, once the company has established such a reserve, the company is no longer free to reduce or eliminate the reserve as long as it remains subject to the risk so represented, unless permission to adjust the reserve is granted by the state insurance department."

Next we consider whether the "additional reserve" was a "life insurance reserve" within the meaning of the Code. It seems clear that the establishment of the "additional reserve" was the exercise of good business judgment, was in the best interest of policyholders and beneficiaries, and had the approval of the State of New Jersey. Admittedly, however, these factors are not determinative when definitions under the tax laws of the United States are involved.

Taxation of insurance companies has always involved some specific treatment by Congress in recognition of the peculiar nature of the industry. Thus, it has been acknowledged that part of the money taken in by the Company as premiums and part of the money earned on investments really belong to the policyholders. *United States* v. *Atlas Life Insurance Co.,* 381 U.S. 233, 247, 85 S. Ct. 1379, 14 L. ed. 2d 358 (1965). Accordingly, it became necessary to make provision for accounting procedures to be consistent with this approach by incorporating the use of "reserves." [10]

In 1942 Congress defined reserves as being based on recognized mortality tables and an assumed rate of interest. The definition was intended to broaden the concept of reserves rather than to restrict it.[11] There is no indication since that time that Congress intended to exclude other factors which would make the calculations of the reserve more precise or accurate. Indeed, in the 1959 Life Insurance Company Tax Act Congress

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[10] 8 Mertens, supra, n. 2, §§ 44.16, 44.17.

[11] S. Rep. No. 1631, 77th Cong., 2d Sess. (1942), reprinted in 1942-2 C.B. 504.

recognized that a company might determine that it was necessary to weaken or strengthen its reserves[12]

The pertinent portion of the statutory definition, 26 U.S.C. § 801(b)(1), reads:

> * * * 'life insurance reserves' means amounts
> (A) which are computed or estimated on the basis of recognized mortality * * * tables and assumed rates of interest, and
> (B) which are set aside to * * * liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance * * * contracts * * * involving, at the time with respect to which the reserve is computed, life * * * contingencies.

It may be seen that the "basic reserve" applicable to a lump sum payment is fully covered by this definition.

The Commissioner appears to argue that the "additional reserve" does not qualify because the optional mode of settlement involved in this case does not create any liability on the insurance company until such time as elected by the beneficiary. The Commissioner characterizes the transaction as the purchase of an annuity by a beneficiary with the lump sum proceeds of the policy.

We disagree and find that the insurer, in making payment under the specific settlement option involved in this controversy, does not enter into a new contract with the beneficiary but merely carries out the contractual obligation which arose with the initial issu-

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[12] Sections 806(b) and 810(d): *See also.* H.R. Rep. No. 34. 86th Cong., 1st Sess. (1959), reprinted in 1959-2 C.B. 736, 794.

ance of the life insurance contract. *See* 19 *Couch on Insurance 2d* § 81:4. We see nothing in the statute which requires the construction which the Commissioner advocates and believe it contrary to generally accepted insurance law. Indeed, the government's position would come as somewhat of a surprise to the policyholder who pays the premium with the understanding that his beneficiary has the choice to take the optional settlement—at the values set out in the policy and regardless of any inclination of the insurance company to the contrary.[13]

While it may be said that as to any one individual policy it could not be determined at issuance that the settlement option would be exercised, there is no doubt that as to the entire class of policies, utilization of the option was not speculative but a fact thoroughly established by experience in a large number of claims throughout the industry. For all practical purposes, then, the obligation of the Company to meet the "strain" was just as certain and definite as it was to meet the lump sum payment requirements for which the "basic reserve" was established.

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[13] The Senate Committee report, in discussing the definition of life insurance reserves under § 201(C)(2) of the predecessor Act, said in part, "The elimination of contingent claims from the House bill is to permit the liability arising from insurance contracts providing for the payment of the proceeds in installments certain for a specified period and a continuation of their installment payments to a beneficiary so long as he might live, to be classified as a reserve if the contract involved a life contingency even if some part of the liability was held to meet noncontingent claims." S. Rep. No. 1631, 77th Cong., 2d Sess. (1942), Reprinted 1942-2, C.B. 504, 612. We interpret this to mean that the Senate Committee would recognize a reserve to meet the settlement option contingency if it were formulated at the time the policy is issued.

The fact that the computation for the reserve included elements other than mortality tables as assumed rates of interest, is not sufficient to disqualify the "additional reserve." There is nothing in the statue which states that these two elements are the only factors which are permissible and that all others must be excluded. In the factual context present here, we can perceive no considerations which would require us to adopt a construction of the Act so narrow as to mandate the exclusion of circumstances which would tend to make the calculation of the reserve more exact.

Congress obviously sought to prevent abuse, and with this, of course, we thoroughly agree. The additional elements used here accomplished exactly what Congress did intend. We cannot ignore the fact that the additional elements of lapse rate, rate of election, and lowered mortality rates of the insured resulted in substantial reductions of the reserve. The recalculation to the lower levels in 1956 was at the request or insistence of the New Jersey Insurance Commission which felt that the reserves were higher than need be. In a real sense then the adjustment of the reserves and inclusion of additional elements was necessary to establish compliance with New Jersey law. We need not hold that this action was necessary to meet the "required by law" test but we do note that Congress was aware of the extensive, continuing supervision of the insurance industry by the states. It is obvious that subjecting the reserves to the scrutiny of the state regulatory agencies is an additional safeguard against overreaching by the companies.

There was testimony in this case to establish that if the challenged elements had not been used in the

computations, the reserves would have been four or five times as high and would have been considered excessive by New Jersey. The substantial actuarial data used in this case and the approval by the State Commission which resulted in a realistic rather than an inflated reserve lead us to conclude that a tunnel vision approach to the Act here would result in distortion rather than a proper construction. The "additional reserve" represented money due the policyholders just as truly as did the "basic reserve."

The final shot fired by the Commissioner is that the "additional reserve" is a "deficiency reserve" and, thus, specifically excluded by the Code. The first and obvious question is, what is a "deficiency reserve." It is a technical term having a specific meaning in the industry which must be used in interpreting the definition of the Act. *Alinco Life Insurance Company* v. *United States*, 373 F. 2d 336 (Ct. Cl. 1967).

The statutory definition, 26 U.S.C. § 801(b)(4), reads:

> * * * that portion of the reserve * * * equal to the amount * * * by which—(A) the present value of the future net premium required for such contract, exceeds (B) the present value of the future actual premiums and consideration charged for such contract.

The "deficiency reserve" is a concept in the industry which resulted from the rigid formulas imposed by state regulatory agencies in calculating "basic reserves." Many states required that the "basic reserve" for a policy was to be computed on the basis of the experience or mortality table in use at the time the policy was sold even though it was known at that time that life expectancy was increasing. This meant that in many instances the reserve was computed on the basis of a life expectancy lower than reality and

therefore the premiums charged would be larger than necessary. Some companies set premium levels which they felt were adequate in view of the lengthening of life expectancy but which were less than that which strict adherence to the tables would require. The state required that in such a situation a "deficiency reserve" be set up to account for the difference between the premiums which should have been charged according to the mortality tables and those which were actually paid by the policyholder."

It may be seen that one of the distinguishing characteristics of a "deficiency reserve" is that it is calculable at the moment of issue of a policy. At that time, the premium actually charged and that required by the standard mortality table are known and the "deficiency" in premium may easily be established. The adoption of updated and more accurate mortality tables resulted in the elimination or decrease of many "deficiency reserve" requirements for policies sold thereafter.

A "deficiency reserve" is not used to increase a policy "basic reserve" which was adequate when issued.[15] With this explanation as a background, it is clear that a "deficiency reserve" as that term is used in the industry is not applicable to an "additional reserve" which is set up after the policy is issued and to deal with problems that arose *after* issue.

When the definition in the Act is read in conjunction with the industry meaning[16] of the term, it is

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[14] See MacLean, Life Insurance, (9th ed. 1962), at page 73.

[15] As one of the witnesses explained at the trial of this case, "deficiency reserves" relate only to the situation at the time a policy is isued, and there is no situation after a policy is issued which would require a "deficiency reserve".

[16] 8 Mertens, *supra*, § 44.15 at pp. 36, 37. *See also* General Life Insurance Co. v. Commissioner of Internal Revenue, 137 F. 2d 185, 190, n. 1 (5th Cir. 1943).

clear that the Commissioner was in error in considering the "additional reserve" as a "deficiency reserve." Here the "additional reserve" could not be ascertained at the time the policy was issued, and it was established to meet events which occurred many years after issuance of the policies.

Recognizing that the unresolved problems of the tax accountability of insurance reserves are many and complex, we have trod a narrow path charted by the specific factual situations present here and our opinion should be so understood. We emerge, concluding that the decision of the Tax Court was correct, and therefore its judgment will be affirmed.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

United States Court of Appeals for the Third Circuit

No. 73-1169

THE MUTUAL BENEFIT LIFE INSURANCE COMPANY, APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE, APPELLANT

Present: SEITZ, Chief Judge and HUNTER and WEIS, Circuit Judges

Order

It is Ordered that the opinion heretofore filed be corrected as follows: The last sentence of the first full paragraph on page 3 of the slip opinion shall read:

> We are concerned here, therefore, with the computations of an amount which is to be entered on the balance sheet of an insurance company as a liability and, thus, has significant tax consequences.

By the Court,

JOSEPH F. WEIS, JR.
Circuit Judge.

Dated: JANUARY 8, 1974.

APPENDIX C

United States Court of Appeals for the Third Circuit

No. 73-1169

THE MUTUAL BENEFIT LIFE INSURANCE COMPANY

vs.

COMMISSIONER OF INTERNAL REVENUE, APPELLANT
(T.C. Docket No. 3671-70)

On Appeal From a Decision of the Tax Court of the United States

Present: SEITZ, Chief Judge and HUNTER and WEIS, Circuit Judges

JUDGMENT

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed. Costs taxed against appellant.

Attest:

THOMAS F. QUINN,
Clerk.

DECEMBER 12, 1973.

A true copy:
THOMAS F. QUINN,
Clerk.

APPENDIX D

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 801 [as amended by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112.]

(a) *Life Insurance Company Defined.*—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b)), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)).

(b) *Life Insurance Reserves Defined.*—

(1) *In General.*—For purposes of this part, the term 'life insurance reserves' means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident

insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

(2) *Reserves Must Be Required By Law.*—Except—

(A) in the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation,

(B) in the case of policies issued by an organization which meets the requirements of section 501(c)(9) other than the requirement of subparagraph (B) thereof, and

(C) as provided in paragraph (3), in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

* * * * *

(4) *Deficiency Reserves Excluded.*—The term "life insurance reserves" does not include deficiency reserves. For purposes of this subsection and subsection (c), the deficiency reserve for any contract is that portion of the reserve for such contract equal to the amount (if any) by which—

(A) the present value of the future net premiums required for such contract, exceeds

(B) the present value of the future actual premiums and consideration charged for such contract.

(5) *Amount of Reserves.*—For purposes of this subsection, subsection (a), and subsection (c), the amount of any reserve (or portion thereof) for any taxable year shall be the mean of such reserve (or portion thereof) at the beginning and end of the taxable year.

(c) *Total Reserves Defined.*—For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

The term "total reserves" does not include deficiency reserves (within the meaning of subsection (b)(4)).

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ *1.801–4 Life insurance reserves.*

(a) *Life insurance reserves defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term "life insurance reserves" (as defined in section 801(b)) means those amounts—

(1) Which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest;

(2) Which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies; and

(3) Which, except as otherwise provided by section 801(b)(2) and paragraphs (b) and (c) of this section, are required by law. For the meaning of the term "reserves required by law", see paragraph (b) of § 1.801–5.

For purposes of determining life insurance reserves, only those amounts shall be taken into account which must be reserved either by ex-

press statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute. Moreover, such amounts must actually be held by the company during the taxable year for which the reserve is claimed. However, reserves held by the company with respect to the net value of risks reinsured in other solvent companies (whether or not authorized) shall be deducted from the company's life insurance reserves. For example, if an ordinary life policy with a reserve of $100 is reinsured in another solvent company on a yearly renewable term basis, and the reserve on such yearly renewable term policy is $10, the reinsured company shall include $90 ($100 minus $10) in determining its life insurance reserves. Generally, life insurance reserves, as in the case of level premium life insurance, are held to supplement the future premium receipts when the latter, alone, are insufficient to cover the increased risk in the later years. For examples of reserves which qualify as life insurance reserves, see paragraph (d) of this section. For examples of reserves which do not qualify as life insurance reserves, see paragraph (e) of this section.

(b) *Certain reserves which need not be required by law.* Section 801(b)(2) sets forth certain reserves which, though not required by law, may still qualify as life insurance reserves, provided, however, that they first satisfy the requirements of section 801(b)(1) (A) and (B) and paragraph (a) (1) and (2) of this section. Thus, reserves need not be required by law—

(1) In the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, and

(2) For taxable years beginning before January 1, 1970, in the case of policies issued by an

organization which met the requirements of section 501(c)(9) (as it existed prior to amendment by the Tax Reform Act of 1969) other than the requirement of subparagraph (B) thereof.

* * * * *

(d) *Reserves which quality as life insurance reserves.* The following reserves, provided they meet the requirements of section 801(b) and paragraph (a) of this section, are illustrative of reserves which shall be included as life insurance reserves:

(1) Reserves held under life insurance contracts.

(2) Reserves held under annuity contracts (including reserves held under variable annuity contracts as described in section 801(g)(1)).

(3) Reserves held under noncancellable health and accident insurance contracts (as defined in paragraph (c) of § 1.801-3) and reserves held under guaranteed renewable health and accident insurance contracts (as defined in paragraph (d) of § 1.801-3).

(4) Reserves held either separately or combined under contracts described in subparagraphs (1), (2), or (3) of this paragraph.

(5) Reserves held under deposit administration contracts. Generally, the reserves held by a life insurance company on both the active and retired lives under deposit administration contracts will meet the requirements of section 801(b) and paragraph (a) of this section. However, reserves held by the company with respect to the net value of risks reinsured in other solvent companies (whether or not authorized) shall be deducted from the company's life insurance reserves. See paragraph (a) of this section.

(e) *Reserves and liabilities which do not qualify as life insurance reserves.* The follow-

ing are illustrative of reserves and liabilities which do not meet the requirements of section 801(b) and paragraph (a) of this section and, accordingly, shall not be included as life insurance reserves:

(1) Liability for supplementary contracts not involving at the time with respect to which the liability is computed, life, health, or accident contingencies.

(2) In the case of cancellable health and accident policies and similar cancellable contracts, the unearned premiums and unpaid losses (whether or not ascertained).

(3) The unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies (and guaranteed renewable life, health, and accident policies) not included in life insurance reserves. (However, such amounts shall be taken into account under section 801(a)(2) for purposes of determining whether an insurance company is a life insurance company.)

(4) The deficiency reserve (as defined in section 801(b)(4)) for each individual contract, that is, that portion of the reserves for such contract equal to the amount (if any) by which—

(i) The present value of the future net premiums required for such contract, exceeds

(ii) The present value of the future actual premiums and consideration charged for such contract.

(5) Reserves required to be maintained to provide for the ordinary operating expenses of a business which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, and unpaid brokerage.

(6) Liability for premiums received in advance.

(7) Liability for premium deposit funds.

(8) Liability for annual and deferred dividends declared or apportioned.

(9) Liability for dividends left on deposit at interest.

(10) Liability for accrued but unsettled policy claims whether known or unreported.

(11) A mandatory securities valuation reserve.

(f) *Adjustments to life insurance reserves.* In the event it is determined on the basis of the facts of a particular case that premiums deferred and uncollected and premiums due and unpaid are not properly accruable for the taxable year under section 809 and accordingly, are not properly includible under assets (as defined in section 805(b)(4)) for the taxable year, appropriate reduction shall be made in the life insurance reserves. This reduction shall be made when the insurance company has calculated life insurance reserves on the assumption that the premiums on all policies are paid annually or that all premiums due on or prior to the date of the annual statement have been paid.

APPENDIX E

MacLean, *Life Insurance* (9th ed.)

Premium Rates

CHAPTER 6

The premium is the consideration which the person insured pays to the insurance company for a life-insurance policy. The premium may be a single payment but is usually an annual payment, payable either for life or for a limited term of years, depending on the kind of policy. An annual premium may be payable in semiannual, quarterly, or monthly installments. The word "installments" is used here because it was formerly the universal custom to calculate all life-insurance premiums on an annual basis so that, where premiums were paid oftener than annually, any unpaid "installments" for the policy year current at death were an indebtedness deductible from the amount of insurance. The usual practice now is to compute semiannual, quarterly, and monthly premiums on a basis which does not treat such premiums as installments of an annual premium and which does not require payment of any "fractional premiums" which would have been payable after the date of death. On this basis, the premium required is, of course, slightly greater than on the "installment" basis.

The elements which enter into the calculation of premium rates for a life-insurance policy are (1) the rate of mortality, (2) the rate of interest, and (3) the rate of expense, in which is included any provision for contingencies not covered by the margin expected from the mortality and interest rates assumed.

The first two elements, the rate of mortality and the rate of interest, determine the amount of the *net premium*. The net premium is that premium which *in the aggregate* will be sufficient to pay all claims on the assumptions that deaths take place exactly according to the mortality table adopted as a basis for calculation and that the net premiums will be invested so as to yield the rate of interest assumed in the calculations. The net premium provides for payment of the proceeds of the policy as a claim by death, by maturity as an endowment, or upon surrender. It does not provide for expenses of operation or for contingencies. However, if, as is usually the case, the assumptions made about future rates of mortality and interest are conservative, "profits" will arise which will be available for other purposes such as expenses, contingencies, and refunds ("dividends") [1] to policyholders. Theoretically, however, the net premium provides only for the contractual policy benefits.

The procedure in constructing a table of premium rates for practical use is first to calculate the net premiums and then to add to these the amounts considered necessary to cover expenses and contingencies and, in the case of stock companies, profit. The total amount so added to the net premium is the *loading*. The net premium increased by the loading is the *gross premium*, which is the premium payable by the insured and which is stated in the policy.

In determining both net premiums and gross premiums for practical use, a distinction must be observed between premiums for participating policies and those for nonparticipating policies. In the case of participating policies the cost to the policyholder is not determined by the premium rate but by the gross premium *less* any refunds or "dividends" which may

[1] Dividends are discussed in Chap. 8.

become payable. Consequently, although the premium rate should not be so high as to be excessive or out of line with corresponding premium rates in other companies, it will normally be somewhat higher than is considered necessary for safety. The mortality table and the rate of interest used to calculate the *net* premium will both be chosen on a basis which provides some margin. A table of mortality will be used which shows mortality rates higher than those actually expected and a rate of interest assumed which is less than the rate deemed likely to be earned. The amount of loading for expenses and contingencies will normally be conservative. This does not mean that the policyholder is being overcharged. An annual adjustment is made, through the payment of dividends, which results in a "net cost" corresponding approximately to the actual experience of the company with regard to mortality, interest, and expense.

In the case of nonparticipating policies, the premium payable is the actual cost to the policyholder since there are no refunds or dividends. Therefore, it must be computed on a realistic basis, i.e., on assumptions as to mortality, interest, and expense which reflect fairly closely the expected experience in all three respects. Some margin of safety must be provided in the assumptions used in computing premiums for nonparticipating policies, but competition prevents the use of excessive margins.

We shall now proceed to explain the method of calculating *net* premiums on the basis of a specified mortality table and rate of interest. These calculations are made in the same way whether the policy is participating or nonparticipating.

Net Single Premiums. Although single-premium policies are of minor importance, we shall, for sim-

plicity, explain first the calculation of net *single* premiums.

In all theoretical work, such as the calculation of net premiums, it has been usual to assume that death claims are paid at the *end* of the policy year in which death occurs. This is not in accordance with the facts, since claims are paid immediately upon proof of death and title, and the policy contract generally so provides. The assumption that payment of claims is made at the end of the year of death, however, simplifies the calculation of premiums, and it is an easy matter to adjust the actual premium rates to allow for the immediate payment of claims. As death takes place on the average in the middle of the policy year (the year from any one anniversary of the date of issue to the next) and as a period of about 1 month, on the average, elapses between the date of death and payment of claim, the adjustment for immediate payment of claims should be an amount sufficient to provide for about 5 months' loss of interest on the sum insured.

* * * * *

CHAPTER 7

The Policy Reserve

Calculation of the Reserve. On the level-premium plan the net premiums are just sufficient, in the aggregate and on the basis of the assumed rates of mortality and interest, to pay all death claims as they become due. The total net premiums paid each year are, for a time at least, greater than the amount of death claims, and a fund is thus created from the excess payments with interest thereon. The fund so formed from the accumulated excess payments is technically called the *policy reserve,* or simply the *reserve.* With-

out it, future premiums on the level-premium plan would be insufficient. Maintenance of this fund is thus a necessary part of the level-premium plan.[1]

It should be particularly noted that the reserve is accumulated on the basis of the *assumed* (or "tabular") rates of mortality, not on the basis of the *actual* mortality experience. If, as will usually be the case, the actual death claims are lower than those assumed and provided for in the net premium, the difference is a "gain from mortality" which will increase the company's surplus funds until distributed to the policyholders (or stockholders) as dividends.

When a policyholder dies, the reserve in respect of his policy is "released" and makes up part of the amount payable. The actual "insurance," or "risk," is constantly being reduced, and the cost of insurance each year on the level-premium plan is, therefore, determined not by the full sum insured but by the *net amount at risk*, i.e., the difference between the full sum insured and the reserve. This principle of a reducing amount at risk, with correspondingly decreasing "insurance," is fundamental to the level-premium system and is the reason why it is practicable to furnish insurance for the whole of life without increasing the annual cost to a prohibitive amount at advanced ages. Failure to understand that fact has been responsible for criticisms of the level-premium plan involving the assertion that under that system the person insured forfeits the reserve at death. That is not the case.

On the assessment plan of life insurance, death claims are paid by a levy or assessment on all those

[1] The reserve is carried as a liability in the financial statements of life-insurance companies since it represents an obligation to the policyholders. The term "fund" does not refer to any specific allocation of assets to offset this particular liability.

who have been insured. On that basis no *reserve funds* are necessary if one assumes that the assessments will be paid. The "reserves" sometimes held by assessment associations are therefore really safety or guarantee funds. Life-insurance companies pay death claims under policies on the 1-year-renewable-term plan out of current premiums, and the reserve at any time on such policies is therefore merely the proportionate part of the net premium for the unexpired period of risk. For insurance on the level-premium plan the amount to be held as reserve follows directly from the method by which the premiums were calculated.

The reserve may be explained from another point of view. When a policy is issued, the discounted, or present, value of all the net premiums is, as has been explained in the previous chapter, equal to the discounted value of the benefit promised in the policy, namely, payment of the sum insured at death. At any time after the date of issue, the then present value of the remaining net premiums will be less than at the date of issue, since fewer of them remain to be paid, while the value of the insurance has increased because the age of the insured has increased and the date of payment has drawn nearer. At any time after the date of issue of the policy the difference between the increased value of the insurance and the decreased value of the future net premiums must be provided for by funds in hand; otherwise, the company will not be able to meet its liability. The difference, or fund in hand, is the reserve, and it can be demonstrated that the amount of the reserve obtained in this way is, as it should be, the same as the amount obtained by the accumulative process.

There follows a numerical illustration of the method of calculation of the reserve on an ordinary-life policy by the *accumulative* process.

In this illustration we have, for simplicity, based the calculations on a relatively small number insured (1,000) and have taken the deaths each year to the nearest whole number. The amounts of the reserves thus arrived at are therefore not quite the same as would be obtained by a more exact calculation in which the numbers of assumed deaths each year would correspond *exactly* with the rates of mortality according to the table, i.e., would be (for 1,000 or fewer lives) a whole number and a fraction—representing an *average* experience. The important thing for our present purpose is not the exact amounts of the reserves each year but the method of arriving at them.

On the basis of the 1958 C.S.O. Table with interest at 2½ per cent, the net annual premium at age thirty for an ordinary-life policy of $1,000 is $14.80. If 1,000 such policies are issued, the accumulation of the reserve fund (on the simplified basis as to death claims stated above) for the first 3 years will be as follows:

First-year premiums (1,000×$14.80)	$14,800
Interest thereon at 2½ per cent	370
Total before paying death claims	15,170
Death claims (1,000×2.13) taken as	2,000
First-year reserve	13,170
Second-year premium (998×$14.80)	14,770
Total fund beginning of second year	27,940
Interest thereon at 2½ per cent	699
Total before paying death claims	28,639
Death claims (998×2.19) taken as	2,000
Second-year reserve	26,639
Third-year premiums (996×$14.80)	14,740
Total fund beginning of third year	41,379
Interest thereon at 2½ per cent	1,035
Total before paying death claims	42,414
Death claims (994×2.25) taken as	2,000
Third-year reserve	40,414

In an exact calculation the *number* of deaths in the first year would be assumed to be 2.13 (not 2), since that is the rate of mortality per 1,000 at age thirty, and the assumed *amount* of death claims would therefore be $2,130 instead of $2,000; the calculation would be similar for the second and third years. Also, the number of survivors at the end of the first year paying a second premium would be 997.87 instead of 998, etc.

The above illustration shows that the total reserve is simply the accumulation, at the *assumed* rate of interest, of the net premiums received *less* the death claims provided for by the mortality table.

At the end of the first year, for example, the total reserve is $13,170. At that time there are 998 survivors, so the reserve on *each policy*, i.e., the first-year reserve per $1,000 of insurance, is $13,170÷998, or $13.20. Since the premium paid on each policy was $14.80, upon which interest of about $0.37 was earned, the actual cost of insurance per $1,000 in the first year was only $1.97 ($14.80 *plus* $0.37 *less* $13.20). It should be remembered, however, that this figure results from assuming death claims of $2,000 instead of the theoretically correct amount, $2,130, and is therefore slightly lower than the true cost of insurance on the bases of mortality and interest assumed.

In the same way, the reserve per $1,000 of insurance at the end of the *second* year is $26,639 ÷ 996, or $26.75, and at the end of the *third* year, $40,414 ÷994, or $40.66. If the calculation were to be continued in a similar manner until the last survivor dies at age ninety-nine (and, of course, using exact rather than approximate figures), it would be found that the reserve per $1,000, i.e., per policy, would reach exactly $1,000 at the end of the final year.

While the reserve *per policy* can be arrived at in the manner just described, it is important to realize that such a figure has no real significance as applied to an individual policyholder but is merely an *average* or a *factor* applicable to a large number of policies or to a large amount of insurance. * * *.

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